GOVERNMENT REGULATION OF INSURANCE COMPANIES.

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The risks or hazards to which man and his economic interests are subject may be separated into two classes: (1) speculative risks resulting from general price fluctuations, and (2) the risks of production and consumption.[1] The former fall upon a class as a whole, and hence are not readily transferred by insurance. The latter affect either individuals or small classes. They may therefore be borne by those upon whom they originally fall, or they may be shifted to other shoulders, or finally they may be distributed over the group as a whole. Primitive races are not only largely under the dominion of the aleatory forces, but they have no systematic method of distributing the losses arising from this source. Consequently the weaker individuals and those less endowed with foresight are rapidly eliminated. Nevertheless, the natural law of survival has never been allowed to operate without restraint. The family, the tribe and the nation in ancient times provided more or less effectively for the weak and unfortunate. Christianity introduced a new ideal and a new institution: the ideal of a universal brotherhood and the church as the active agency by which the burdens were alleviated. The church came to regard the care of the unfortunate and distribution of alms as its duty if not its inherent right. It thus gained a hold upon medieval society which it could probably never have attained upon purely religious grounds—a fact which may partially account for its early hostility to all forms of life insurance. Gradually the church has either abandoned or been forced to give up this field to various voluntary,

[1] For a more complete analysis of the classification of risks, see Prof. H. C. Emery on "The Place of the Speculator in the Theory of Distribution," and articles there cited in Publications of the American Economic Association, Third Series, Vol. I, No. 1, pp. 103 *et seq.*

industrial and social organizations whose bond of union is economic rather than religious. These organizations are (1) those formed primarily for industrial purposes including the guild, the labor union, the combination and the corporation. While established for other purposes, each of these institutions exercises a profound influence in distributing the risk of industry to the individual members of the group; and (2) those organized primarily for transferring risks, that is the insurance companies. The insurance companies were slow in developing, but once their economic function was appreciated their growth has been phenomenally rapid. They have thus taken upon themselves many of the burdens formerly assumed by the family, the church, and the state. The state therefore, as the ultimate sufferer from the losses which the insurance companies may lighten by transferring to many shoulders, is forced by every mandate of self-interest to see that all forms of legitimate insurance are so conducted in principle and practice that its benefits may minister to the largest possible number consistent with safety and economy.[2]

Insurance, therefore, necessitates the organization of the several groups upon which the risks naturally fall into permanent associations. Such organizations are theoretically possible without the intervention of the state. But under such circumstances rights and duties must necessarily be settled within the company itself. A government, with courts to adjudicate controversies and an army to enforce discipline, becomes essential to the existence of these organizations. Such a condition needs only to be mentioned to be discredited. The state exists to establish and maintain justice and protect life, liberty and property. As the relations of individuals are coming to be determined more and more through their membership in various economic and social organizations, the state is in duty bound to extend its functions until it includes the direct regulation of all association within its borders.

[2] For arguments opposing regulation, see paper by Henry C. Lippincott, on "State Supervision Not Properly a Function of Government," "Insurance Press," Nov. 7, 1906; and "Testimony of J. H. McIntosh, in Hearings before the Judiciary Committee, H. of R., in Relation to Insurance," 1906, pp. 120-137.

The above considerations apply to all forms of associations which are economic in their purpose. The state is under further and especial obligations to regulate insurance companies. The contract between the company and the insured is necessarily of a contingent nature [3] and often extends over a long period of time. The ability of the insured to continue payments may be impaired. To forfeit payments already made as was the custom in the early days of life insurance, defeats the purposes for which insurance exists. Such a practice not only leaves the policyholder without protection but also absorbs the means with which he might have protected himself in his hour of distress. To render insurance safe, the payments must be larger than is usually necessary to meet mortality losses and the expenses of conducting the business. Hence a return in the form of dividends. Payments less dividends thus constitute the net cost of the policy. If the price of groceries is exorbitant at A's store the housekeeper is in a position to patronize B or C. If company A is extravagant in its management or unfair in its distribution of dividends, what recourse has the policyholder? To surrender his policy? Even under the most liberal surrender values and with the most meager dividends such a process is always costly. His old policy has been more expensive than a term policy for the same period and the new policy purchased in its place must be taken out at an advanced age and therefore at a higher annual expense. Indeed the only recourse the individual policyholder has had under such conditions in the past except for the slight aid given by the state and the stress of competition has been an early death. Again, the enforcement of the contract often falls upon the widow or orphaned children who have in many cases neither the means nor the ability to protect themselves, and in this case to employ counsel usually makes insurance too expensive to be expedient. From these considerations it may be concluded:

(1) That regulation is a necessary function of government;

[3] Rosselet, F., Fourth International Congress of Actuaries, Vol. II, p. 240.

(2) That insurance conducted by large organizations requires more regulation than that by smaller ones; [4]

(3) That short-term insurance such as fire, marine, casualty, surety etc., demands less regulation than full life insurance;

(4) The insurance usually taken by the economically weaker classes such as industrial insurance and certain forms of assessment insurance demands more efficient regulation than that patronized by the economically stronger classes; and

(5) So salutary is the effect of insurance in all its legitimate forms that wherever and whenever the state is unable to secure safe and economical insurance from private companies through effective supervision it would seem to be its proper function if not its duty to undertake to provide such insurance through its own direct agency.

The ultimate social and economic purposes which the state has in view should largely determine, first, the scope and character of such regulation, and second the particular government authorities to which the supervision may properly be intrusted.

From the social standpoint the object should be to provide insurance adapted to the needs of the weaker industrial classes so economical and so safe that such classes may enjoy its benefits as fully and freely as their means allow. From the economic standpoint the purpose should be to secure an organization for each company so efficient and safe that insurance may be provided at the least possible cost and so representative in its government that every interest may receive its benefits in equitable proportion to its contributions to the common fund. To secure these ends four radical changes in our present policy of insurance legislation and administration is desirable if not absolutely necessary.

(1) In laws relating to incorporation and internal government of insurance companies;

(2) In the provisions for a reasonable and adequate system of publicity;

[4] This principle is applied in Germany. See paper by Dr. Von Knebel Douberitz, of Germany, in Fourth International Congress of Actuaries, Vol. II, p. 230.

(3) The transference of the control of the interstate insurance from the state to the federal government; and

(4) In the abolition of much of the present restrictive legislation.

First, the insurance company must be made up of many individuals in order to be safe and economical. Its management must be intrusted to a few to be efficient. Hence arises the problem of establishing and maintaining a strong and responsible government. The failure to accomplish this necessary end has been one of the chief causes of our recent insurance troubles. The Armstrong reports says:

"Notwithstanding their theoretical rights, policyholders have had little or no voice in the management. Intrenched behind proxies, easily collected by subservient agents and running for long periods, unless expressly revoked, the officers of these companies have occupied unassailable positions and have been able to exercise despotic power. Ownership of the entire stock of an unmixed stock corporation could scarcely give a tenure more secure. The most fertile source of evils in administration has been the irresponsibility of official power." [5]

The first step then to be taken in effecting this reform consists in remodeling our laws relating to the business organization of the companies. At this point the insurance problem is a part of the larger corporation problem—and even more complicated. For the insurance company is mutual in its natural and therefore likely to be such in its organization. The policyholder thus occupies a dual position, at once stockholder and patron. He understands the latter position, but usually has failed to appreciate the fact that his well-being as a patron depends upon how efficiently he performs his duty as a stockholder. This will be no easy problem to solve. Its effective solution will largely depend upon three conditions: first, the active interest of the policyholder; second, the efficiency of the machinery provided by which he expresses his will as to the personnel of the management and the policy of

[5] Report of Armstrong Committee, Vol. X, pp. 366-7.

the company; and third, the system of publicity provided upon which his judgment rests.

The present condition is exceptional. The policyholders are thoroughly arroused by the revelations of the Armstrong and other investigating committees. The control of vast interests is at stake. Such a campaign as that which has been waged is likely to occur only once or twice in a lifetime. When apathy succeeds interest, then the machinery governing the election of directors and the dissemination of information needs to be so easily and almost automatically operated that the administration shall under all circumstances be at once efficient and responsible. When, in the progress of time and a fuller understanding of this problem much of the restrictive legislation of the present day shall have been outgrown and abandoned the future historian will point to the Armstrong legislation chiefly as the first conscious attempt to control insurance companies through responsible self-government.

Second, such regulation depends upon intelligent action by the policyholders and such action is possible only when based upon full and accurate knowledge of facts and conditions. Its success necessitates a system of adequate publicity both as to financial conditions and as to methods of operation. Publicity is also the most powerful deterrent to fraudulent and selfish management known to political science. Says Commissioner Garfield in his last report:

> "A most striking and important result immediately followed the investigation of the Bureau—the railroads cancelled substantially the secret rates, illegal or improper discriminations, and in many cases the discrimination in open rates. Thus a widespread system of railway discrimination was wiped out of existence because of the discovery of the agents of the Bureau, and before any prosecutions were brought thereon. The shippers of oil advise the Bureau that for the first time in many years they are now rapidly obtaining equality of treatment from the transportation companies." [6]

The various investigations into the insurance companies'

[6] Annual Report of the Commissioner of Corporations, 1906, pp. 4-5.

management will undoubtedly prove more valuable for the publicity given to their affairs than from their influence on legislation.

Two methods of securing publicity are practicable:

1. Through government investigations and examinations; and

2. Through independent audits by professional accountants.

The former is the method generally employed in this country, Germany, France and Switzerland. The latter is confined chiefly to England, and there has proved a most valuable aid to the government and to the policyholder. As is well-known, the regulation of insurance companies in England is entrusted to the Board of Trade, which relies chiefly, not upon examinations by government officials, but upon the report of the companies regularly audited by public accountants.[7] It is perhaps more to the credit of the effectiveness of the independent audit than to any other regulative device that we may attribute the high standing of the English insurance companies. Public attention has been repeatedly called to the desirability of uniform accounting and the independent audit by public accountants appointed by and in the interests of the policyholders, by the American Association of Public Accountants on several occasions [8] and lately by the Massachusetts Commission on Insurance Law. The report of the latter says:

"The recent investigations in New York have revealed, among other evils, two serious defects in the internal and external regulation of insurance companies: namely, an unscientific and inefficient system of internal accounting, bookkeeping and auditing, and a superficial and inadequate examination of the companies by the insurance department of that State. As a result the officers of the companies have wasted funds by unauthorized, illegal and improper expenditures; misleading financial statements have been made to insurance department, policyholders and the public

[7] "On the Province of State Supervision of Life Insurance Companies," by James Chisholm, Fourth International Congress of Actuaries, Vol. I, p. 1006 *et seq.*

[8] Journal of Accountancy, April, 1906, p. 525; August, 1906, pp. 290, 297; November, 1906, p. 74.

and the majority of directors and trustees have been kept in ignorance of many doubtful and irregular transactions."

The committee, therefore, advocates the passage of an act compelling companies to adopt a uniform system of accounting and to submit to independent auditing by certified public accountants and concludes:

"If the system proposed had been established in New York several years ago many of the familiar evils of the past two years would have been averted. It would have been impossible, under such a system, for the officers of the greater companies to have concealed their transactions from the policyholders or the insurance departments."

Third, in centralized governments the question as to whether the local or the federal government is best fitted to exercise efficient control over insurance companies does not arise. In England, France, Italy, Russia, Sweden, Belgium, and other states of this form, insurance is naturally regulated by the general government. In federal governments this problem may under certain conditions assume proportions that entirely overshadow all others. Theoretically the solution is simple enough. All economic activities that are entirely local are properly regulated by the local government. All economic activities that are interstate, are properly regulated by the federal government. Such is the distribution of functions in regard to the regulation of insurance in Germany, Switzerland, Canada and Australia. Such is the distribution of functions in regard to commerce and transportation in the United States. With respect to insurance the United States has clung to a method all other federal governments have discarded and which she too has abandoned for all other similarly organized economic institutions. The reasons for this anomalous situation are not far to seek:

(1) Insurance is a modern institution. When the federal constitution was adopted insurance so far as it existed was entirely local in character. As the insurance business developed and companies were instituted their regulation was

assumed by the state governments without any direct consideration of either its advantages or disadvantages;

(2) The transference of the control of the insurance companies from the states to the federal government under the authority granted congress by the commerce clause would be attended with far-reaching legal and economic consequences. This follows from the doctrine that a state has no power to impose restrictions on commerce among the states even in the absence of federal legislation,[9] except such as may be necessary for the enforcement of its police regulations. Consequently insurance officials would be forever protected on account of past offences from either criminal prosecutions or civil suits brought under laws of other states. And further, all rights of the policyholders under the statutes of other states would be invalid.[10] And

(3) The state governments naturally enough object to loss of power and lessened patronage.

The present method of regulation has, however, become well-nigh intolerable. The companies have been subject neither to effective self-government nor to wise public control. Irresponsible management on the one hand, fifty self-seeking state jurisdictions with conflicting statutes, retaliatory measures, "hold-up" acts, fake examinations, and unequal if not exorbitant taxation on the other, until insurance in some of its forms has become unduly expensive and often more risky than the hazards which it is its function to alleviate. Why, it may be asked in all seriousness, with fifty states and territories constantly at work, grinding out statutes, and fifty insurance departments continually examining companies and issuing voluminous reports, why has our insurance history been disgraced by one period of widespread bankruptcy, and now by another of extravagant and fraudulent business management. Is it lack of authority? In the words of the Armstrong report:

"This condition has not resulted, as has been stated, from lack

[9] Welton *vs.* Missouri, 91 U. S. Reports, 275.

[10] Unpublished address, Prof. F. Green, Urbana, Ill.

of legal authority either to inquire into the irregularities now exposed or to compel reports which would have exposed them. No substantial amplification of the powers or authority of the department seems necessary." [11]

The failure of the present system is due chiefly to the fact that it fails to recognize the essential principles that apply to the regulation of insurance companies.

(1) The government authorities controlling any economic organization should include within its geographical limits the constituent economic society thus regulated.

(2) The insurance company is an indivisible and inviolable organism [12] and, therefore, must of necessity be regulated as a unit.

(3) The several states are primarily interested in the operations of the interstate insurance companies only so far as they affect the citizens of that state.

State regulation is therefore destined to fail. For if the several states attempt to regulate all the companies operating within their borders as organic units, fifty statutes relating to the method of organization result. Unless such legislation is uniform each insurance company will find itself compelled to withdraw from all states whose legislation is not in harmony with that in which it has its charter. Again, if the states attempt to regulate the companies only so far as their operations within their geographical borders are concerned, no sufficient safeguard against a contaminated business management, the fruitful soil of most of the evils that arise within its own domain, is provided.

As the failure of state regulation has become more and more apparent and as the fundamental reasons therefore have been gradually appreciated, a growing and persistent demand for federal regulation has developed. The strength and vitality of this demand is indicated by the following phenomena:

1. The replies to the letter sent out by Senator Dryden to

[11] Report of Armstrong Committee, Vol. X, p. 360.

[12] *Cf.* papers by Adan and Le Jeune, Third International Congress of Actuaries, London, 1900.

some eight thousand associations and individuals throughout the United States in September, 1905, asking for an expression of opinion on the suggestion of President Roosevelt that interstate insurance companies be regulated and brought under federal control showed that 83.3% of those answering were in its favor; [13]

2. The work of the National Association of Insurance Commissioners, a body that has accomplished more than any one other single agency for uniformity of state legislation and administration is in itself a tacit admission of the desirability of uniformity, a condition whch only federal regulation can successfully accomplish;

3. The agitation in the present congress in behalf of the Ames bill is based upon and supported by the same demand; and,

4. The organization of the life-insurance companies into a permanent association, as proposed by President Morton of the Equitable in a circular letter of December 3, 1906, which has recently been perfected and is to-day in session in New York is in answer to the demand for uniformity of laws, governing the regulation of insurance companies.

None of these organizations for securing uniform statutes seem likely to accomplish the desired end. The National Association of State Insurance Commissioners has been at work for 37 years and the task before it grows larger and more hopeless. The "model" act for the District of Columbia has received the approval of many of the leading authorities on this question and yet when one stops to consider that this same act was devised "to get around the inability of congress to legislate" under the commerce clause of the constitution, and further, that the present statutes governing the insurance business in the District of Columbia enacted as recently as 1901, to use the exact words of the Commissioner Insurance for the District, "are the worst in existence" [14] one may well stop to

[13] "The Commercial Aspects of Federal Regulation of Insurance," by John F. Dryden, p. 17.

[14] Hearing before the Committee on the Judiciary in Relation to Insurance, Wash., 1906, p. 140.

inquire whether the leopard is to change his spots or whether we may yet find that figs are to be gathered of thistles.

Of the two methods by which direct federal regulation may be secured that by the amendment to the national constitution is far preferable from every standpoint except that of practicability. For it would effect no change in a legal status of either officers or policyholders and again, it would avoid a long period of litigation and judicial decision in the courts. It would seem from past experience, however, that only in case of a great popular uprising is it possible to change our fundamental law. Such being the case, is it possible to secure federal regulation by act of congress?

Agitation for such regulation began in 1865 as a direct outgrowth of the passage of the national banking act of the preceding year. A memorial was presented to congress asking relief from the burdens of state supervision. The first bill actually introduced was in the year 1868 following the lines marked out by this memorial. In 1877 as a direct outgrowth of the insurance bankruptcies of 1874 a second attempt was made, but without result. The Patterson bill of 1892, the Platt bill in 1897, and the Dryden bill in 1906 have followed in succession. The political, economic, and social difficulties in the path of federal regulation by acts of congress have already been indicated. In addition to these, however, there is a constitutional question involved which political scientists may consider and constitutional lawyers argue, but only the Supreme Court may finally decide. The question is, Has congress authority under the clause granting it power over commerce among the several states to regulate interstate insurance companies? The Supreme Court in a series of decisions, Paul vs. Virginia (8 Wall. 168) 1868, Hooper vs. California (155 U. S. 648) 1894, N. Y. Life Insurance Co. vs. Cravens (178 vs. 389) 1899, and Nutting vs. Massachusetts, 183 vs. 553, 1901, has definitely stated that "issuing a policy of insurance is not a transaction of commerce" and "these contracts are not articles of commerce in any proper meaning of the word." The court also went so far as to declare in Paul vs. Virginia that "such contracts are not interstate trans-

actions, though the parties may be domiciled in different states" on the ground that the contract was not completed until the policy was delivered in the state where the insured lived.

Notwithstanding the decision of the court, in these and other cases, a considerable number of men whose opinions are eminently worthy of respect believe that federal regulation through this method is the only practicable one and that it is worth while to test the constitutionality of such an act. They look for a favorable decision on the following grounds:

1. In all the cases above referred to the issue was brought under a state statute. In none of them was the validity of an act of congress called in question. In none of them did the decision hinge upon the constitutional classification of the business of insurance; [15]

2. The Supreme Court has shown a tendency in some of the more recent cases to adopt a more liberal interpretation of the meaning of the commerce clause. In the lottery case [16] it was held by a majority of the court on the construction of a federal statute that the transportation of lottery tickets by express involved interstate commerce, and it was therefore a valid act. Further, the clause is to be interpreted in the light of present conditions and consequently in the words of Justice Brewer "it operates to-day upon modes of interstate commerce unknown to the fathers, and it will operate with equal force upon any new modes of such commerce which the future may develop." [17] If, therefore, the transportation of lottery tickets from state to state is interstate commerce and the word "commence" is to be interpreted in terms of its present-day meaning, is it not to be concluded that insurance may yet be held by the court to be a part of or at least involve commerce?

3. Again, it is evident from the language used that the

[15] Majority Report of the Committee on Insurance Law, Am. Bar Association, Aug. 24, 1905.

[16] 188 U. S., 321.

[17] In re Debs, 158 U. S., 591.

court had in mind the transaction by which the contract between the company and the insured was completed. That is, the delivery of the policy to the policyholder by the company's resident agent. Such a transaction is evidently not commerce in its ordinary meaning of the word. This act, however, while an important part of the work of the company, from the legal point of view, is of minor importance from the economic standpoint. A more complete analysis discloses that the insurance company is engaged in creating time utilities and selling the commodities by which such utilities are for the time being represented to those who are in need of them. A simple case will illustrate: An insurance company for and in consideration of the sum of $432 or thereabouts, will sell to a man of 35 years of age, in good health, $1000 in gold or other lawful money, payable upon proof of his death. Here is a purchase and a sale, the essential element of trade or commerce. That the trade is in terms of gold or other lawful money does not prevent it from being commerce, otherwise those who buy and sell gold and gold coin must be excluded from that field of economic activity. Neither is it an essential condition of commerce that the commodities be "subjects of trade and barter offered in the market" that is, bought for the purpose of selling again for the sake of a profit. Such a limitation of the term would exclude the farmer who sells eggs direct to his city customer from partaking in commerce, while admitting the retailer who buys to sell again. Under this construction a retail clothing store would not be engaged in commerce when selling articles of clothing of its own manufacture to the individual who is to wear them, but would be so engaged when selling clothing made by the regular manufacturers of clothing. Commerce refers to an especial kind of business transaction, that is, the process by which titles to commodities and other economic utilities are transferred. The banker who buys and sells commercial paper is engaged in commerce, so is the broker when buying and selling securities, so is the real-estate agent when buying or selling land; so is the manufacturer who sells his own goods; and so is the insurance company when selling insurance. The term insurance

has at least three meanings as ordinarily used: (1) as a legal term it refers to the formation and character of the contract between the parties; (2) as a commercial term it refers to the process by which the relations between the parties are established; and (3) as an economic term it refers to the effect of the institution upon the distribution of wealth. The courts have confined their attention chiefly to the first meaning and have failed to appreciate the importance of the second. From the standpoint of the company the commercial process of selling insurance is second in importance only to the actuarial basis upon which its security rests. There can be little doubt that when the Supreme Court is obliged to pass upon the constitutionality of an act of congress which declares that interstate insurance business is interstate commerce, and that policies are articles of commerce and instrumentalities thereof,[18] it will consider from every point of view the terms commerce and insurance, and when it does so it will be obliged to recognize the fact that insurance involves commercial transactions if, indeed, it is not predominantly an integral part of commerce itself.

4. Certain other considerations are entitled to a hearing. James Wilson speaks of "bills of exchange, policies of insurance and *other* mercantile transactions;"[19] Hamilton in his opinion upon the constitutionality of the proposed United States Bank objected to the enumeration of the powers of congress as stated by the Attorney General, on the ground that among other powers he had failed to include "the regulation of policies of insurance."[20] Furthermore, insurance law had its origin in and is generally treated as an integral part of the law merchant or commercial law; and again, the regulation of insurance is in the most advanced commercial countries administered as a part of the department of commerce.

Fourth. When a responsible government has been provided for our various insurance companies, ensuring an administra-

[18] Dryden Bill, Sec. 16.

[19] Wilson's Works, I, p. 335.

[20] Hamilton's Work, Lodge's ed., III, p. 203.

tion at once representative and efficient, when an adequate system of publicity has been established through which the policy-holders and the administration are kept in vital touch, when, further, the government which regulates is in economic harmony with the insurance institutions which it controls, then, and not till then, will it be possible to abandon the policy of restrictive legislation, which has been at once the necessary concomitant and the vital weakness of state regulation.